CLEARING-HOUSE AND DOMESTIC-EXCHANGE FUNCTIONS OF THE FEDERAL RESERVE BANKS[1]

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THE proposed plan to reform the American banking system presents a number of interesting and difficult problems. Few of these deserve more serious and thoughtful consideration, and none appear to have received in public discussions of the pending bill less attention than those involving the domestic-exchange and clearing-house functions of the federal reserve banks. For the most part, the problems presented are new. They arise from an intricate combination of the powers and provisions contained in the bill which have not heretofore existed in banking practise anywhere. Their solution, therefore, must be worked out slowly in the light of experience yet to be gained.

This is particularly true of questions relating to the exchange functions of the proposed regional banks. Many unsuspected difficulties may, and doubtless will, present themselves. Much uncertainty is occasioned by our inability to determine in advance the extent to which the federal reserve system will be supported by existing banks, and especially what classes of banks will lend their support.

No vital principles of banking would be violated in granting the proposed functions to regional banks respecting the clearance of checks. Indeed, the plan seems to be a timely attempt to extend in wider circles certain useful principles already thoroughly established and approved. If a practical way to accomplish this object could be found, great economic benefits no doubt would be derived by commerce and be shared by members of the federal reserve banks through the application of the clearing principle to country-wide checks, instead

[1] Read at the meeting of the Academy of Political Science, October 15, 1913.

of having that invaluable aid to business limited as it is now to use in particular cities and in restricted localities. But the two practical difficulties in the way of a universal extension of the principle are the questions of the costs involved and of the place where the burden of these costs shall be laid. Bankers for years have faithfully studied the question, and have found no satisfactory solution except by applying the clearing principle in a limited way within nearby and easily accessible regions.

When clearing houses were first proposed many objections were made and strongly pressed against the method of swapping checks, which is, in effect, the principle of offsetting debts one against another. Difficulties were overcome gradually, and dangers and possibilities of abuse were reduced by the adoption of rules which grew out of experience, so that now, although the total volume of clearings is enormous, the risk is practically *nil.* Certainly the losses actually incurred in handling so large a volume of business through clearing houses are very much less than would be the case were settlements made in cash. Probably in this country ninety-five per cent of the total volume of business settlements is effected by checks. Certainly the settlements of balances resulting from clearings do not as a rule require more cash than five per cent of the total amount cleared. Consequently, in all centers where large payments are made, settlements through clearings are of much greater utility than would be the use of money itself, and quite as indispensable. It follows, therefore, that if the costs of extending this principle throughout the country be not so great as to become prohibitive, and if the burden of these costs can be justly distributed, all good reasons for opposing an extension of the idea to checks other than local will be removed. But it is a far simpler matter to make this statement than to suggest the means for its accomplishment.

Here it may be well to draw attention to the distinction between offsetting a debt as accomplished through clearing houses and the actual payment of that debt. The passing of items through the clearing house does not constitute payment. All items cleared are under the rules returnable within time

limits. This must be allowed for a number of reasons. Actual payment of an item does not take place, and cannot be considered to have taken place, until that item shall have been received at the paying bank and sufficient time allowed to examine the check and endorsements in order to determine whether or not they are correct and the check is good.

In order that we may have clearly in mind during this discussion the apparent intentions of the framers of the new bill respecting the clearance of checks, the extension of the par privilege and the classes of items which shall be included, it may be well to quote in full the portions of the bill as written relating to domestic exchange and making provision for the exercise of clearing-house functions by the Federal Reserve Board and for the delegation of these powers. They are:

(1) It shall be the duty of every federal reserve bank to receive on deposit, at par and without charge for exchange or collection, checks and drafts drawn upon any of its depositors or by any of its depositors upon any other depositor and checks and drafts drawn by any depositor in any other federal reserve bank upon funds to the credit of said depositor in said reserve bank last mentioned, nothing herein contained to be construed as prohibiting member banks from making reasonable charges to cover actual expenses incurred in collecting and remitting funds for their patrons. The Federal Reserve Board shall make and promulgate from time to time regulations governing the transfer of funds at par among federal reserve banks, and may at its discretion exercise the functions of a clearing house for such federal reserve banks, or may designate a federal reserve bank to exercise such functions, and may also require each such bank to exercise the functions of a clearing house for its member banks.

(2) Among the powers of the Federal Reserve Board specially enumerated is the following:

To perform the duties, functions, or services specified or implied in this act.

The powers here conferred are ample and exceedingly broad. They are so sweeping that the Federal Reserve Board

may at its pleasure assume either directly or through federal reserve banks a large part of the clearing-house functions of the whole country, so far as member banks are concerned, and thereby reduce all existing clearing-house associations to minor organizations for clearing the remaining volume of checks on banks not members of the system. Elsewhere in the bill the intention seems clearly to be implied that this shall be done. At least, we find that the power of clearing houses, which has been so effectively invoked to stop panics through the use of clearing-house loan certificates, is to be abolished. The intention seems clear that each federal reserve bank shall effect for its own members the free clearance of all checks and drafts drawn by individuals and others on a member bank, or drawn by a member on itself or on another member, and also the same classes of items drawn by any bank located in any other district on the federal reserve bank of its own district. This would include, and cause to circulate at par throughout the country, practically all classes of checks and drafts in common use for making trade payments, except those of three kinds. These are:

(1) Checks drawn on banks not members of any federal reserve bank.

(2) Checks circulated by individual depositors and drawn on banks in other federal reserve districts.

(3) Checks drawn by a member of one federal reserve bank on a member bank in another district.

In the practical operation of the plan the heavy discrimination here made against these three classes of checks would cause them soon to disappear. Easy means, however, would be found to evade the discriminating charges in the cases of classes 2 and 3, while in the case of class 1 non-members of reserve banks might and would arrange to draw their checks on other banks which were members, and thus secure at least within the districts of their location the free clearing privilege.

For all practical purposes, therefore, we may consider that it is the purpose of the bill not merely to facilitate clearing of checks between the members of a district federal reserve bank, but also to relieve commerce as a whole of tolls in the

way of exchange charges heretofore imposed by the banks and found by them to be necessary because of the costs involved in handling the business. This inference is further warranted by the fact that it is made the duty of the federal board to promulgate regulations governing the transfer of funds at par among federal reserve banks.

The exception permitting banks to make reasonable charges "to cover actual expenses incurred in clearing and remitting funds for patrons" is comparatively unimportant and relates, of course, to shippers' drafts and similar documents drawn in the course of the collection of trade debts. These instruments are not circulated or employed in making trade payments. Under this permissive clause exchange charges could be extended, at most, only to include collection items and drafts on correspondents in other cities sold by the banks over their own counters. Under the proposed plan, however, drafts of the latter class necessarily would quickly disappear. Their place would be filled by cashiers' checks or drafts drawn by members on the federal reserve banks, because these instruments would serve the same purpose and would, of course, be free of exchange charges.

If the saving of exchange tolls on trade, which in the aggregate amount to an enormous sum annually, can be effected through the machinery of regional banks, and if the business can be cleared as expeditiously as it is now handled, and if the federal reserve banks shall be able to absorb and bear the costs which will fall upon them, the plan should be made effective by all means, despite the opposition of individual banks or of any sectional group or association of them. It will be found that opposition to the plan will not come from banks located in reserve and central reserve cities. All such banks will rejoice at the proposed undertaking. The contention which the city bankers have steadily made, that they have struggled with this problem in good faith, that they have always handled the business at a loss, or at least with returns entirely incommensurate with the amount of labor and risk involved, will quickly be demonstrated. Insurmountable opposition may be expected from country banks, because of the

taking away from them of the imposition of exchange charges. This has long been a source to them of legitimate and well earned revenue, and they should not be called upon to give it up. I cannot state the fact more plainly than by saying that if free clearance of checks be forced upon country banks they will not, in my opinion, join the federated system. These bankers may be mistaken in their views, but they will first have to be shown how they shall be relieved of their burdens before they can be expected to assent to free collections and the absorption of the costs to them involved. It should be borne in mind that the burden falls upon country banks, and to a very large extent also upon banks in ordinary reserve cities, of paying the cost of shipping money back and forth seasonally. The country bank pays the express tolls and loses interest on money in transit outward, when currency is needed in the interior, and back again to the reserve cities when the currency movement reverses. Banks in ordinary reserve cities at their own expense perform the same service in and out from larger centers. In all agricultural regions, where the supply of cash is insufficient for the seasonal needs, the banks are obliged to transport the necessary funds in large amounts. Take the movements of cotton during the active season—small banks are required daily to pay out in many cases an amount of cash greater than their capital stock. This money is moved at their own expense. They are at the same time required to receive and give credit daily for drafts against cotton shipments. These drafts are credited and the proceeds are thus made subject to check, the bank being obliged to make cash payments against them. The drafts are carried as "exchanges in transit" until they reach a larger central point, and there they are credited to the interior bank, against which further currency may be drawn. These operations involve large credit risks as well as large actual cash outlays. For both of these items a local bank is entitled to reimbursement. The services are indispensable to the crop movement. The splendid manner in which the country banks have supplied this service from year to year has become so much a matter of course as to attract no attention and elicit

no praise. The only way in which the country bank is able to reimburse itself for these heavy burdens is, under the existing scheme, to compel the producer or tradesman who needs to have the money brought out from centers to absorb the transportation charges by paying exchange on the drafts which he deposits for collection and credit. Later on, the merchant, whose needs in the payment of purchases cause this self-same money to be sent back again to trade centers, must be required to pay that cost in the way of exchange on drafts purchased by him.

This is the reason why the interior merchant prefers to use his check on a home bank. He thus evades the cost as well as gains time to meet the check. The country bank does not object, because its rightful charges are deducted when the check is presented eventually and remittance made for it. The city bank is obliged in the end to absorb the charge or throw it upon its depositor. While admittedly a desirable thing to be accomplished, it will be seen that the proposed plan to throw this burden at once upon the federal reserve banks without first knowing and carefully counting the irreducible cost, would constitute a risky experiment. This burden might be so great as to absorb the net earnings of federal reserve banks and even to involve the integrity of their capital.

The cost of the physical transportation of money is increased because of the wide extent of the producing regions of this country geographically and because of the annual ebb and flow of currency to meet seasonal requirements. The movement is a natural one, and while the burden of it may be shifted in the manner proposed, a certain fixed cost cannot be escaped either by legislative enactment or by human ingenuity. It is as much a necessary item of expense as is freight paid for transporting merchandise, and like it, must fall somewhere. Trade practise naturally and very properly has placed it upon the recipient of the benefit.

If we could have one central bank with numerous branches, the cost of effecting not only the normal currency movement, but also the universal clearance of items of the classes named

might be so greatly reduced as to become negligible by resorting in the case of checks to book entries made at the head office and affecting the accounts of branches. Such entries would of course affect the reserves of the member banks concerned, but they would not affect the reserve of the federal bank itself, every liability created by the deposit of a check being immediately offset by a corresponding debit to the account of the drawee. It would not matter, either, in the case of currency movements, if there should be an accumulation of funds at one branch for a considerable time. There these funds might remain and be counted as reserve quite as well as if they were held at the head office. Neither would it matter if a large amount of bank notes should be presented for redemption at a branch. Such notes could be redeemed, retired and held on hand at the branch without cost or transportation charges until they might again be required. This economical arrangement cannot be established where there are twelve independent units in the system, each struggling under the necessity always of maintaining its own equilibrium of reserves and liabilities. In the case of every federal reserve bank, should a system of inter-district clearings be attempted, the actual transportation of reserve money back and forth would become inevitable. At first, the plan might be tried out in a limited way between the members of a single regional bank, all of which necessarily maintain balances at the reserve bank. With a federal reserve bank as the center, and with the banks constituting its members taken as a whole, the organization might be considered a miniature or localized central banking system, wherein the principle of clearing might easily be applied successfully amongst the members. But even such an arrangement, although apparently both practicable and just, would be greatly to the advantage of city banks, and decidedly to the disadvantage of country banks.

However, it is not a matter of profit and loss to the member banks which is to be considered so much as it is a question of the practicability from the point of view of the federal reserve banks themselves, and of the means by which, if at all, the business can be undertaken by them and successfully carried on.

In view of the position of the country bank, which I have endeavored to state clearly, it would seem that the plan must be made sufficiently attractive to induce the interior banks to support it. Certainly, without their support in large numbers the scheme would fail, because the volume of business to be collected is so large that the existing scale of exchange charges could not possibly be absorbed by the federal reserve banks.

The considerations raise the following questions:

I. How shall the objections of the country banks fairly be met? How shall the costs they now bear be so shifted that the country banks may be able to support the plan?

The provision that these banks shall be allowed to charge exchange on documentary drafts and collections is good, and it is abundant to take care of that portion of the business. In addition to this, however, all transportation charges on bank notes to and fro, for whatever purpose shipped, should be borne by the federal reserve banks. Under the law, the reserves maintained at federal reserve banks may not be distributed, in any event. In consequence, it will become necessary, if the proposed plan shall be made effective, for every member in providing funds for clearing checks through its regional banks to maintain much larger balances than mere reserve requirements demand. The maintenance of these increased balances will involve either their borrowing at federal reserve banks or decreasing their loans at home, and consequently this cost might fairly be offset by the free transportation of bank notes. Finally, interior banks should be permitted to carry at least one-third of their required reserves permanently with reserve agents so as to entitle them to receive the benefits of special reciprocal arrangements which will be effected by nearly all banks in reserve cities with those in other reserve cities for the clearance of checks drawn on non-members of regional banks. Arrangements of this kind, where not already existing between banks, will become necessary in any event. Such inducements as are here suggested, coupled with the advantage of speedy conversion of current checks into reserve funds, and the fact that the maintenance

of reserves would become easier and the lending power of the banks be increased in consequence, would bring into the system nearly all the interior banks.

II. The second and equally important question is, how these concessions, if granted, will affect the federal reserve banks.

The estimated normal annual movement of currency from reserve centers to the intrior for crop-moving purposes is between $200,000,000 and $250,000,000. The movement varies according to circumstances. The return movement at seasons' ends is substantially the same, so that the total movement to and fro is approximately not less than $400,000,000 annually. The average cost of transporting currency by express for all distances in this country is probably about forty cents per thousand dollars. Making allowance, however, for short hauls, and for shipments of currency by registered mail under insurance, the cost of transportation may be conservatively estimated at twenty-five cents per thousand dollars (exclusive of interest on money in transit). This would amount, therefore, to an annual minimum charge on the federal reserve bank — if it should assume these charges — of not less than $100,000. Let us suppose that twice as much more currency should be moved back and forth in the course of a year by members located in manufacturing and industrial centers, for pay-rolls, exchange and reserve purposes, at an equal average cost. Then we should have a total yearly expense incurred by federal banks in currency movements of not less than $300,000. If this were the end of the matter, such a charge would be of no consequence and could easily be absorbed. But a far heavier burden would lie in the cost of handling the items collected. This involves labor, postage, stationery and, in the case of checks on other federal banks, loss of time (which is usually expressed by banks in terms of interest for the average number of days required to receive returns). In clearings between the members of a district alone, no such loss of time would be incurred; but in inter-regional clearings the interest loss actually suffered would be measured by the gold reserve required to be carried against the credit balance

created by the deposit in one regional bank of checks on other regional banks. It is difficult to compute this cost, but it would be very heavy unless each federal reserve bank should be permitted to have an account with every other such bank, and to offset the balances "due to" and "due from" other regional banks before computing their required reserves. This, of course, would materially reduce the cost of inter-district clearings. But, it would be open to the same objections, if not to all the abuses of the existing practise of "double-headed" accounts between individual banks.

Fourteen years ago, after careful investigation, the New York clearing-house association ascertained the actual cost to its members of clearing out-of-town checks or, as they are now called, "inland exchange." A schedule of charges estimated then to be sufficient to cover the actual cost, but no more, was adopted and under penalties was made obligatory on all members. Certain nearby cities and towns were placed on the discretionary list, which meant that the members of the clearing house should have the privilege either of exacting a charge or of clearing checks on such discretionary points free; and as a result, in actual practise checks on all discretionary points (except under most unusual circumstances involving very large amounts) have been handled free. Charges of one-tenth of one per cent (one dollar per thousand) were imposed upon checks drawn upon banks within a region roughly defined as that part of the United States east of the Mississippi and north of the Ohio; a charge of one-quarter of one per cent (two dollars and a half per thousand) was imposed on checks drawn on banks west and south of the territory named. The plan worked satisfactorily and with the exception of special interpretations and rulings made by the clearing-house committee remained unaltered for thirteen years. During this time, naturally, the volume of business largely increased, new and better methods were adopted in the handling of collections, mail and transportation facilities were improved, so that it appeared to the members of the association early last year that the time had arrived for a careful investigation of the whole subject, with a view to a revision of the schedule of charges if it should be found desirable.

A committee was appointed for this purpose in April, 1912, began its work immediately, and continued without intermission for six months or more. The members of the committee approached the subject with open minds, and after procuring all necessary data from the members themselves and having the presidents or other officers of member banks before them, as well as receiving deputations from bankers' associations of nearby states and from neighboring cities, reached their conclusions and made a report showing that the gross volume of out-of-town checks cleared by members of the New York clearing house for the year 1911 was approximately $4,859,187,900; that the gross income of the members from exchange and collection charges imposed on the business handled was $2,139,551. From this there was deducted exchange paid to other banks, amounting to $1,176,162; cost of postage, rents, stationery, salaries, *etc.*, $569,461.78; estimated loss of interest (through giving in special cases immediate credit for items in process of collection) $296,460; total costs $2,042,083.78; net income, $97,467.22, which, distributed between sixty-four active members of the clearing house, represented an annual increment of income to each of about $1,500, or an average of about two cents per thousand dollars. The report also showed that of the total volume of out-of-town checks handled by the members, 71 per cent was drawn on the discretionary or free points; 24 per cent on points costing $^1/_{10}$ of 1 per cent, and only 5 per cent on cities involving a cost of ¼ of 1 per cent. It was further shown that the average time consumed in the collection of all inland checks, including those on the free list, was 4.19 days. This time varied from 2.95 days for Washington, D. C., and 3.24 for Baltimore, all the way up to 8.93 days for Los Angeles, 8.92 for Seattle, and 9.40 for San Francisco.

As a result of these painstaking and thorough investigations the sub-committee found that the existing scale of charges certainly did not do much more than bring the banks out without loss, even if that were done; and they consequently reported that the charges were not excessive. They recommended that the main body of the rules and regulations of

the clearing house in respect to exchange charges outside of New York city remain unchanged. They suggested, however, that within certain restricted territories easily accessible to New York, and for reasons which in each instance were peculiar to the areas involved, the rules should be modified so that outside of the discretionary points already existing all banks and trust companies in the states of Massachusetts, Rhode Island, Connecticut, New Jersey and New York which should engage themselves to remit to the members of the New York clearing-house association at par in New York funds, on the day of receipt of the items, should likewise be placed on the discretionary list. The report was adopted and the new rule went into effect.

As evidence that the interior banks were better satisfied with the old arrangement, it may be stated that out of a total of 1,827 banks located in the new discretionary region only 306 thus far have availed themselves of the privilege afforded for the free circulation of their customers' checks in the city of New York. It is only fair to make the statement, however, that the interior banks concerned insisted that the New York clearing house should adopt the Boston system, so that they should be obliged to make only one par remittance, and that to the clearing house daily, instead of making numerous separate remittances to individual members of the clearing house. This is where the rub came, and their contention is not without merit. Nevertheless, it appears that the average interior bank prefers to make its own arrangements with New York banks whereunder it shall make remittances, and to stipulate its own tolls, rather than have the checks of its customers circulated free under conditions that involve labor and expense to the bank. This, no doubt, is a fact, and it would be no less true were the terms imposed by a federal bank instead of by associated banks. The interior banks will not absorb the cost in either case, nor can they afford to do so without reimbursement in some form.

It will be seen from the foregoing figures that the average cost to New York banks of collecting out-of-town checks is about forty-two cents per thousand dollars, including, of

course, checks on discretionary points which actually were handled free. By far the greater part of this cost is represented by exchange and collection charges imposed by interior banks. This amounted during 1911 to $1,176,162, or an average of about 24 cents per thousand on all checks collected. If checks on discretionary points be excluded, and only those be considered on which the New York banks themselves imposed an exchange charge, then the average cost would be $1.45 per thousand. For our purposes it is correct to include the whole volume of business handled, for in no other way can we arrive at a fair estimate of the cost of handling such items by the federal reserve banks.

Under a widely supported system of regional clearings the exchange item of costs could be very greatly reduced and probably nearly eliminated. For our purposes we shall consider that it is entirely eliminated, leaving only loss of time and the cost of what might be termed "overhead charges," including the operation of the business. The time loss in the case of New York banks amounts to only about six cents per thousand dollars, because for the most part, although credit is immediately given, interest is not paid on balances until the items deposited have been collected. In the case of regional banks, this charge, if considered at all, would be higher because of the larger reserves of gold required to be carried against deposit liabilities. It would amount probably to eight cents per thousand dollars. But this charge could be eliminated by permitting each federal bank to offset balances due "to" and "from" other federal reserve banks before computing its reserve. If these two items of cost should be thus removed there would remain the single item covering labor, postage and stationery, and this would constitute the irreducible minimum, which in the case of New York banks is approximately twelve cents per thousand dollars, and in the cases of certain large banks, as much as fourteen cents, by actual tests.

The experience of New York banks, as revealed by the investigations of the inland exchange committee, was surprising in that the average cost of collecting inland checks apparently

had not been reduced within thirteen years, although the banks employed more efficient methods and enjoyed the advantages of more rapid transportation and better mail facilities. Apparently these advantages were about evenly offset by the constantly increasing scale of exchange charges imposed by interior banks and the increasing volume of business handled, despite the restraining influence of the charges imposed by New York banks. The charges collected by interior banks began to increase in 1898, when a stamp tax was imposed on checks, and these charges have continued steadily to increase. The rule among interior banks is to impose a minimum charge per item in the case of single items, regardless of the amount involved, and also a minimum charge of so much per hundred dollars where several checks are involved. The result is appreciably to increase the average cost of collection of checks per thousand dollars, because the average trade check is much less than that amount, while during the period under consideration the established scale of charges imposed by the New York clearing house remained at a fixed rate per thousand dollars. Outside of its own members, this is a condition against which every federal reserve bank would soon find itself contending in respect of inter-district clearings, and one which the Federal Reserve Board would find much difficulty in regulating at par without preparing to absorb heavy costs.

We have made reference to the system which is in effect for the handling of New England checks in Boston by a bureau attached to the clearing house. In this system we find as near an approach as could be imagined to the actual working conditions under the most favorable circumstances which could exist in a federal reserve bank clearing checks for its own members only. It may be well, therefore, to describe the system as affording a practical example of the lowest attainable overhead charge in handling checks on numerous banks in a small and densely populated region.

Briefly, under this system all checks on New England banks are received by Boston banks at par. They are (or may be) collected at par through the clearing house, where the checks are received, recorded and forwarded for collection to the

banks on which they are drawn.[1] The checks are remitted for at par, credit being given the members of the Boston clearing house in the clearing on the second day following the despatch of the items. Interior banks are permitted to make remittances at par in New York exchange, if more convenient; or they may ship currency, when necessary, at the expense of the Boston banks. The system has been in effect for a number of years, and works with perfect satisfaction to all concerned.

The cost of handling checks in this manner is figured on New England items only to be approximately seven cents per thousand dollars. This is exceedingly low, and there are several reasons of a special nature for the allowance of so low an estimate. These reasons are not applicable generally among banks, and would not be in the case of a federal reserve bank. Several of the larger banks in Boston estimate that the actual cost to them is approximately nine cents per thousand. Despite the manifest advantages offered by this system, and the exceedingly low costs obtained, the fact remains that less than ten per cent of the total volume of New England checks received by Boston banks is handled through the clearing house. The competition among Boston banks for the reserve accounts of interior banks compels them to handle ninety per cent of the business directly through their own correspondents, on terms of course more favorable to the interior banks than the clearing-house arrangement. Assuming, from the estimates of the larger banks, that the cost averages nine cents per thousand dollars, it will be observed that this is within one cent per thousand dollars of the actual net cost experienced by New York banks on all checks. This, beyond doubt, is very near—as near, in fact, as it is possible to calculate—the irreducible minimum of overhead charges in handling inland exchange.

Inquiries made by wire to all reserve cities of the United

[1] The advisability of sending checks to the banks on which they are drawn is open to question from a legal point of view, but it is universally done among banks, and with no greater risks than if sent to other banks, except in the legal risk assumed.

States for information of a nature similar to that upon which the figures for New York and Boston are based have brought to hand a mass of reliable data sufficient to confirm the substantial accuracy of the estimated cost of handling items by banks of the whole country. I am convinced that the experience of New York banks, and of those in Boston, Philadelphia, St. Louis, Chicago and all other central reserve and reserve cities, constitutes a fair basis for estimating the cost of handling this business as it necessarily would be conducted by regional banks. In all cases where the same or similar methods of computing the costs are employed, there is remarkable uniformity in the percentage which the daily total receipts of inland items bears to the total deposits of the banks in those cities; and also in the average time required to receive returns on inland checks, and consequently, also, in the relative proportion which the totals of the accounts carried by the banks representing "cash items in process of collection" bear to the total deposits of the banks. There is likewise surprising uniformity in the estimated fixed amount of overhead charges. Wherever discrepancies appear they invariably incline toward very much greater, and never toward less, costs than those here estimated. I am of the opinion that for a time at least, and perhaps for many years, the regional banks could not effect collections so cheaply, except between their own members, as the banks now do through private reciprocal arrangements made on a large scale. The estimated cost, therefore, to the regional bank is probably under, rather than over, that which would actually be incurred in such operations. A large volume of checks is handled by trust companies in the reserve cities and by many banks in smaller places (data of which are not accessible) through special reciprocal arrangements. Such arrangements consist of the mutual exchange of checks within certain territory or of checks drawn on certain specified points which are handled at par; the use of "double-headed" accounts; balances carried by one bank with another bank free of interest; the remittance of accumulated balances at par in exchange on central points at stated intervals; and the employment of various other schemes in-

volving an evasion of direct charges and outlays in the way of exchange paid, but entailing, nevertheless, cost in some form. Leaving these out of account, we may safely estimate that the minimum cost of handling inland checks (other than local checks which pass through clearing houses) excluding the time equation and actual exchange paid (which items the regional banks might possibly escape in the manner already shown) would be not less than ten cents per thousand dollars; that the average time required to receive returns would be not less than 3½ days on nearby points (24 per cent of the total) and 5 days on more remote points (5 per cent of the total); and that the total volume of items always afloat would be not less than 5 per cent of the total deposit liabilities of the banks.

Without going into a bewildering maze of figures, it will be seen from the foregoing data that the actual cost to regional banks, if each such bank should undertake to assume the clearing of checks among its own members, and each also to clear checks drawn directly on all other regional banks, as is contemplated in the proposed bill, would be approximately as follows: Total deposits of the banks of the United States (state and national), $17,000,000,000. Five per cent of this amount would be $850,000,000, representing the amount of unpaid items always outstanding. The average time to collect being not less than 4 days, all inland items included, we estimate $212,500,000 as the daily average amount of "inland" checks which would be received and credited by federal reserve banks; or an annual total (figured on a basis of 300 business days a year) of sixty-three billion, seven hundred and fifty million dollars. On the low basis of ten cents cost per thousand dollars this would amount to an annual cost to the federal reserve banks of $6,375,000 in actual overhead charges. To this should be added at least $300,000 annual expense for movements of currency. Even these enormous charges take no account of the actual bookkeeping and clerical costs involved in effecting the clearance of purely local checks between members such as that which now takes place through clearing houses. In the aggregate, the amount of these clear-

ances is very much larger, but the clearing cost would be inconsiderable. Among all the proposed federal banks the total would probably not amount, in actual cost for clearing local checks, to more than $2,000,000 additional, or to a total for all clearances and charges of $8,675,000, or 4.17 per cent annually upon the total capital of the federal reserve banks if every national and state bank in the United States should join the system. It should be remembered, also, that the volume of business cleared through the regional banks would speedily be increased, and that this enormous charge would be multiplied for three compelling reasons:

(1) The quick convertibility of current checks into lawful reserves.

(2) The removal of the necessity now existing for reciprocal arrangements between banks for any checks except those on non-members, and the diversion of the great volume of business thus handled from present channels into the federal reserve banks, for reserve reasons.

(3) The natural inclination of every person to ride a free horse.

Even the government itself would suffer in its revenues because of the easy availability of free exchange as against the cost of postoffice money orders, and the readiness with which individual checks could be negotiated at par in the trade centers of every federal district. The enormously increased use of checks and their free circulation would, of course, correspondingly decrease the requirements for bank notes. Whereever a check is used it displaces or, rather, satisfies a temporary need for the actual use of an equivalent amount of currency; and if the use of checks be free, the incentive is, of course, to use checks. Consequently, in exactly the ratio in which federal reserve banks made possible the free use of checks, those banks would be working against their own interests and depriving themselves to that extent of the opportunity to keep their notes in circulation. The natural tendency, and probably the ultimate result, of the proposed plan if the federal reserve banks should assume on a large scale the clearing functions would be to make that particular function the

chief business of the federal reserve banks; and, naturally, as in the case of existing clearing houses, that business would be conducted for the convenience of the members and not for or at a profit.

The conclusion, therefore, seems warranted, that, however desirable in theory the proposed plan may be, however beneficial it might be to individuals, to trade in general and to the members of the federal reserve banks in the large cities, it is impracticable, its cost to federal banks prohibitive, and its operation contrary to the interests of the small interior banks. The scheme should not be enforced against those banks unless the concessions suggested shall be granted them.

Finally, the plan is not to be commended because it would tend to relieve trade generally, and individuals in particular, of the burden of paying a fair compensation for the use of credit, which is a trade facility and a trade necessity. The use and enjoyment of these necessarily entails a cost somewhere for benefits supplied and for services rendered. If this burden shall be assumed by the federal reserve banks, the cost, or a large part of the cost, in the end will fall upon the government itself, and will be reflected in the reduced profits derived by the government from the operation of federal banks.

So far as the trading public is concerned, no necessary or desirable economic end will be attained through the establishment of a free system of collecting checks. In the interest of trade, the abolition of fair exchange charges—those now imposed do not seem to be unfair or excessive—and the substitution of an unlimited use of checks to be cleared free by regional banks, is no more desirable or necessary, or in fact, more practicable, than would be the free extension of credit and the abolition of interest charges. One is as logical as the other.

I may say that a strong objection to the plan lies in the fact that under it inflation of credit is possible through kiting of checks;[1] for every check deposited in a regional bank and

[1] "Kiting" is the mutual exchange or loan of checks between two or more individuals or corporations, whereby temporary credits may be enjoyed through fictitiously created balances.

drawn on another regional bank, or deposited by one member of a regional bank on another member of the same regional bank, becomes at once convertible into reserve money and may be so computed irrespective of whether such checks on presentation shall prove to be good or not, or whether the credits were created by "swapping checks." This indeed approaches, if it does not go beyond, the limit of even problematical soundness in the theory of banking.